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# Tearing up spoiled checks

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if any, extra expense or duplication of work. In this connection, a word may be said on the fallacy of regarding fidelity bonds as full security against fraud. While such bonds are necessary, they should be regarded in the same manner as other insurance; that is, every precaution should be taken against the necessity of collecting on them. Further, what good can a bond do unless it is known whether a cause for collection exists?

In all cases where it is economical to do so, mechanical devices should be used as an aid in the compilation and recording of various data required. But they should be understood to constitute an aid to system and not be regarded as the system itself. A hundred million dollars or more are being spent every year in the purchase of mechanical office devices. Much of this equipment is being bought in a hit-or-miss fashion, without a careful study of the economy thereof or of its relation to the general system, or without a careful study of the many devices for sale that may serve the purpose. The result of these hit-or-miss decisions is that much time, effort and money are wasted.

To acquire familiarity with the many devices offered for sale and the use thereof is quite a task, requiring more time and money than it would be profitable for any but the larger corporations to expend. Advice on this subject may well constitute one of the functions of accountancy; but the public accountant, to be in a position properly to advise his clients, must have

available complete information on these subjects.

Having in mind the growing need for system service to clients, there recently has been organized in the technical procedure department of our executive offices a systems division under the direction of a specialist in that field. This division is undertaking to correlate the system efforts of the organization and thereby to serve the system needs of our clients at a minimum of time and expense to them through the practice offices by:

- Furnishing advice on problems of system and organization;

- Supplying system specialists familiar with the individual problem of the client to render such service as he may require;

- Studying the functions of all mechanical devices used in an office, issuing bulletins thereon, and gathering catalogues from the makers thereof, so that this information will always be available to our clients.

- Gathering continually from the practice offices new ideas and developments pertaining to system, which are available to clients through the system specialists in the various practice offices;

- Keeping clients advised of new developments in the field of labor-saving devices.

## Tearing Up Spoiled Checks

**T**HE American Bankers Association, through a protective department which interests itself in the prevention of loss from crime, recently issued a code of rules containing advice as to the proper preparation and use of checks. One of the rules is stated as follows: "Don't erase. Errors should be corrected by writing a new check and destroying those incorrectly written."

There can be no question that the practice of attempting to correct errors made in checks already written is a pernicious one. The correction of an error made in writing a check, either by erasing or by drawing a line through the part erroneously written, offers an excellent opportunity for further alteration by any person who subsequently may come into possession of the check. The only really safe

procedure is to write a new check.

In the light of experience, however, the destruction of voided checks is to be condemned as offering increased possibilities in some instances for the perpetration and concealment of irregularities, the detection of which is difficult.

The negotiation of voided checks as a means of improperly withdrawing funds on deposit probably is not as frequent as the use of various other methods. This, no doubt, is because other ways are easier. Nevertheless it is of sufficiently frequent occurrence to make it a factor worthy of consideration.

In many instances checks are voided because they have been imperfectly prepared, with the result that they are rendered useless for the purpose to which they are intended to be put, although their general negotiability is not impaired. A dishonest employe coming into the possession of such a check sometimes is able to realize thereon. He may then account for the check as having been voided and destroyed, make no entry of the disbursement in the books, and conceal the resulting shortage by any one of various manipulations of the records. He may cover his tracks very effectively by destroying the check after it has been paid and returned by the bank on which drawn.

An employe who occupied a position as bookkeeper and cashier of a small manufacturing concern recently was able to misappropriate several thousand dollars in this manner. His first theft was largely the result of an accident. He had written a check in favor of a creditor of the company, and had procured thereon the signature of an official. As he was about to mail the check, he noticed that he had inadvertently made a mistake in the amount. He brought the situation to the attention of the official who had signed the check, who told him to destroy the erroneous check and prepare a new one, and to make a notation on the stub corresponding to the erroneous check, and opposite its num-

ber in the cash book, that it had been voided and destroyed.

It then occurred to the employe to negotiate the check himself instead of destroying it. Consequently he forged the endorsement of the creditor to whom it was payable, and obtained the proceeds. He did not enter the check in any of the records, but accounted for it as having been voided and destroyed. When he received the next bank statement, he abstracted the check, which had then been paid by the bank, and destroyed it.

In order to bring the disbursements according to the cash book into agreement with the payments shown by the bank statement, he overfooted the net cash and the vouchers payable columns on the disbursement side of the cash book. He then overfooted in the same amount the total column and an expense distribution column in the voucher register.

Having succeeded in avoiding discovery in this instance, he began to repeat the operation, intentionally making mistakes in the amounts of certain checks. No suspicion was aroused on the part of the official whose signature was required, inasmuch as the employe allowed a considerable interval of time to elapse between any two irregular transactions, and because he was always careful to apologize for his carelessness in writing checks. The embezzlement eventually was discovered by accountants during an audit, by footing the cash book and the voucher register, and by comparing the details of disbursements according to the bank statement with the payments shown by the cash book.

Aside from providing dishonest employes with a supply of checks which may be negotiated improperly, the practice of permitting the destruction of voided checks offers an additional means of concealing certain kinds of irregularities.

In most cases—unfortunately not in all, however—the supply of blank checks is controlled, by number or otherwise. Consequently, it is necessary under such cir-

cumstances to account for each check used. A dishonest employee who misappropriates funds on deposit may then follow only one of two courses in attempting concealment. He may record as disbursements the checks used for the improper withdrawal of funds in bank, or he may omit to enter the checks and destroy them after payment and return by the bank.

The first method automatically accounts for the checks used. All that is then necessary is to support the cash book entries by such data as may be required under the circumstances to make the disbursements appear regular.

In many cases, however, defaulters desire to obliterate all possible traces of their operations. Because of the methods of system or audit in vogue, it may be considered difficult to support irregular disbursement entries. Because of forged signatures, irregular endorsements, fictitious payees, etc., it may be deemed unwise to retain spurious checks in the files after they have served their purpose. Consequently the second course may be pursued, namely, that of making no record of the irregular disbursements, destroying the fraudulent checks after they have been returned by the bank, and concealing the shortage by manipulating either the bank reconciliation or the cash book.

In the latter contingency the fact that certain checks are missing remains to be explained. A favorite way to accomplish this result is to account for missing checks as having been voided and destroyed. Where it is known to be the practice to destroy voided checks, this explanation may appear entirely reasonable, and it may be difficult to determine that such is not the case.

The supply of blank checks should be controlled by number, and all numbers accounted for. The practice of having blank checks made up in pads, leaving the number and depositary to be filled in when a check is issued, furnishes dishonest employees with a ready supply of

blank checks by which to misappropriate funds to their own use.

A control cannot be effective if the destruction of voided checks is permitted. Where such is the case there is no tangible evidence to support a statement that a certain check is missing because it was never issued. The door is open for the negotiation of checks presumably destroyed. The opportunity exists for concealing thefts of blank checks to be used for fraudulent purposes.

Consequently there should be a rule in every office requiring voided checks to be retained in the files. When it is necessary to cancel a check prior to issuance, the check should be mutilated by tearing or cutting off the signature. If a check book is used, the voided check should be pasted onto the corresponding stub. If padded checks are used, it should be filed with checks returned by the bank. This procedure prevents unauthorized negotiation of the check, and nullifies the magic of the word "void" in concealing thefts of blank checks. The voided check is available at all times as a visible evidence of what has occurred.

Another method of disposing of voided checks which sometimes is used is that of endorsing and depositing them in the concern's own bank account. While this method has the merit of providing for the retention of voided checks, it is nevertheless a loose way of handling the situation. It inaugurates the policy of allowing checks to be paid incompletely endorsed, and opens up the way to other kinds of embezzlement.

Some safeguards which incur expense do not compare in effectiveness as precautionary measures with this one of preserving voided checks, which costs nothing and may save thousands of dollars.

The American Bankers Association might well change the rule in question, as follows: "Don't erase. Errors should be corrected by writing a new check and preserving those incorrectly written, removing the signature and either pasting the

voided check onto the corresponding stub, or filing it in numerical order with checks returned by the bank."

A voided check is as good a voucher in support of its non-use as for the proper withdrawal of funds from bank.

## An Income Tax Pitfall

A RECENT decision of the United States Supreme Court, rendered in the case of *Marr vs. United States* (45 Sup. Ct. Rep. 575), has an important bearing on the income tax liability of stockholders in corporate reorganizations.

Under the law, the fact that shares of corporate stock increase in value does not subject the holder thereof to a tax on the increase as income. The tax is imposed upon income, and not upon capital invested or property as such.

Further, a bona fide stock dividend is not taxable, according to the decision of the United States Supreme Court in the famous case of *Eisner vs. Macomber*. The rule is that "a stock dividend shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer."

The question raised in the present case was whether or not, in a corporate reorganization, an income tax can be levied on the excess of the value of the stock issued by the new company, over the cost of the stock in the old company.

The effect of the decision which was rendered is that the procedure followed in the reorganization is the deciding factor in determining the propriety of a tax. In general, if the identity of the business enterprise is maintained and there is no change in the proportional interests of the stockholders in the company, then no tax on income can be imposed. But if these identities are not preserved, the imposition of a tax is proper.

The facts in the case were as follows:

Prior to 1913, Marr purchased 339 shares of preferred and 425 shares of common stock of the General Motors

Company, a New Jersey corporation, for \$76,400.00. He held the shares for a number of years.

In 1916 this corporation had outstanding \$15,000,000 of 7% preferred stock and \$15,000,000 of common stock, all of the par value of \$100 per share. It had accumulated a large surplus, so that the value of its common stock was \$842.50 per share. There was then organized the General Motors Corporation, a Delaware corporation, with an authorized capital of \$20,000,000 of 6% non-voting preferred stock and \$82,600,000 of common stock, all of the par value of \$100 per share. The Delaware corporation issued its stock in exchange for that of the New Jersey corporation, on the following basis: one and one-third shares of new preferred stock for each share of old, and five shares of new common stock for each share of old, with cash payments for fractional shares. The Delaware corporation thus became the owner of all the outstanding stock of the New Jersey corporation, and took over its assets and assumed its liabilities. The latter was then dissolved. There remained \$7,600,000 of authorized common stock in the new company, which was not required for the exchange. This was either sold or retained for sale in the future.

Marr received in exchange for his holdings 451 shares of preferred and 2,125 shares of common stock in the Delaware corporation, which, including a small cash payment, had an aggregate market value of \$400,866.57. This was \$324,466.57 greater than the original cost of his stock in the New Jersey corporation. The Treasury Department assessed a tax on this amount, pursuant to the Revenue Act of 1916. Marr paid the tax under protest, and litigation resulted.